DOCKET FILE COPY ORIGINAL


economics
accounting
engineering

ECONOMIC & TECHNICAL CONSULTANTS, INC.

etc

6241 Executive Boulevard
Rockville, Maryland 20852

Telephone: (301) 984-7050
Telecopier: (301) 984-7053
MCI MAIL: (800) 452-8735


RECEIVED

AUG 25 1993

FCC MAIL ROOM

August 24, 1993

The Secretary
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20554

Dear Sir/Madam:

Enclosed are one original and nine copies of the Comments by Economic and Technical Consultants, Inc. on the Notice of Proposed Rulemaking, MM Docket No. 93-215.

Sincerely,

Jatinder Kumar, President

JK/mcm
Enclosure (1)

Admin\FCCRLMK.Cvr
August 24, 1993

No. of Copies rec'd 0+9
List A B C D E

DOCKET FILE COPY ORIGINAL
RECEIVED
AUG 25 1993
FCC MAIL ROOM

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

| | | |
|---|---|---|
| In the Matter of<br><br>Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992<br><br>Rate Regulation | ) | MM Docket No. 93-215 |

NOTICE OF PROPOSED RULEMAKING

COMMENTS OF ECONOMIC AND TECHNICAL CONSULTANTS, INC.

On July 16, 1993, the Federal Communications Commission (FCC) issued a Notice of Proposed Rulemaking (NOPR) and requested public comments. Pursuant to this request for public comments, Economic and Technical Consultants, Inc. (ETC) submits comments on the NOPR.

ETC is a consulting firm with offices in Rockville, MD which provides technical services in the areas related to regulated industries. ETC has a wide range of experience related to various issues especially those related to Cost of Service (COS). Hence, its comments will mainly focus on the COS aspect of the NOPR. ETC's comments are presented below. Because of the time constraint, ETC is unable to submit detailed comments.

## COST OF SERVICE STANDARDS

ETC concurs with the NOPR that the adoption of the COS standards results in just and reasonable rates which will balance the interests of both investors and ratepayers. The procedures for COS studies should be standardized to the maximum extent possible. While detailed COS studies may be required for the big cable companies, there could be abbreviated COS studies for the smaller companies. The revenue requirement for a cable company using the COS standards is established or computed by the following formula:

Revenue Requirement (RR) =
Cost of Service (COS) =
Return on Rate Base + Operating Expenses + Depreciation and Amortization

As indicated in the NOPR, and as incorporated in the above formula, the various elements of COS are:

1. Rate Base
2. Rate of Return
3. Operating Expenses
4. Depreciation and Amortization

In addition, another important element of COS is the test period.

ETC's comments on each of the above elements are presented below.

1. TEST PERIOD: In order to compute COS of a cable company, it is essential to use the data for a period of 12 consecutive months. This twelve month period is known as a "Test Period". The rate base, revenues, expenses, etc. are computed for the test period. The following are two major issues related to the test period.

   a. **Actual versus Projected Test Period.** Some regulatory bodies permit use of the actual historical test period and others allow use of the projected test period. ETC supports use of the actual test period for the following reasons:

      1. The actual data are known and not speculative.

      2. The use of projected data generally results in more challenges to the method and assumptions used in the projections and this generally results in more litigation and expenses.

      3. The projected data is unfair to investors if projected costs and expenses are under projected and is unfair to ratepayers, if projected costs and expenses are over-projected.

   The actual test period data may be adjusted for known and measurable changes which are expected to occur within a reasonable time after the end of the test period. The reasonable time is about six to nine months. The projected test period may be used if it is certain that a cable company will experience drastic changes in the future and the historic data will not be reflective of the future situation.

   b. **Average versus Year End Test Period.** Another issue generally litigated when using the COS standard is whether average or year end test period data should be used. ETC supports use of the average test period data as it results in a proper matching of revenue, investment and expenses. Business organizations including cable companies, generally report their financial data on the average year basis.

2. <u>RATE BASE</u>: Rate Base is generally computed as below:

Rate Base = Plant in Service - Accumulated Depreciation + Working Capital + Acquisition Cost (if allowed) + Construction Work in Progress (if allowed) - Accumulated Deferred Income Taxes (if tax normalization is allowed) - Customer Advances and Deposits.

a. **Plant in Service:** ETC concurs with NOPR that the original book value of the Plant in Service be used. The NOPR describes two other approaches for valuation of the Plant in Service - (1) Replacement Cost Approach and (2) Reproduction Cost Approach. The basic principle underlying these two approaches is the same, i.e., the cost needed to rebuild the system. Both these approaches are speculative and result in allowing a return and depreciation on assumed or hypothetical rather than the actual investments. The proper COS standards should allow investors a return on the actual investment provided by them. The reproduction cost is based on the erroneous assumption that facilities will be designed and installed exactly the same way as the original facilities. This assumption completely ignores changes in technology of both equipment and/or materials and installation.

The use of the original book cost of Plant in Service is not based on any speculation and permits a return to investors on the investment provided by them. The FCC should establish criteria for allowing the Plant in Service in the rate base. The following criteria are recommended:

1. Plants which are currently used and useful in providing regulated service.

2. Plants for which investment is provided by the investors. The plants acquired without costs should be excluded.

3. Investment which represents prudent design and construction.

b. **Excess Acquisition Costs:** ETC agrees with NOPR that no excess acquisition costs should be allowed. The allowance of such costs may not only result in a daisy chain of buy/sell in order to artificially inflate the value of the assets, it may also lead to a disincentive in the replacement of obsolete equipment/material with more modern equipment/material. ETC is also opposed to the amortization of excess acquisition costs. ETC concurs with the NOPR that in case amortization of excess acquisition costs are to be allowed, it should be amortized over a period of 40 years.

c. **Plant Under Construction:** ETC recommends that plant under construction or construction work in progress (CWIP) should not be allowed in the rate base for the following reasons:

1. CWIP is not used and useful. (One of the criteria which determines what costs can be recovered through the ratebase.)

2. The inclusion may result in over construction and imprudent costs as has happened in the case of nuclear plant construction by the electric industry.

3. The inclusion requires current rate payers to pay a return on an investment which will be used by future customers.

The proper method of treating CWIP is to accrue the cost of capital, (i.e., cost of debt, equity, etc.) incurred during construction. Upon completion, if the facility is deemed to be used and useful, the investment along with the accrued costs can be included in the rate base.

d. **Excess Capacity, Cost Overrun and Premature Abandonments:** As stated above, a return should be allowed only on the investment which is prudently incurred and used and useful. The costs associated with excess capacity, cost overruns and premature abandonment do not meet the above criteria. The allowance of these costs will result in excess capacity, unnecessary construction and cost overruns as experience has shown in the case of nuclear plant construction. The mistakes made with nuclear plants should not be repeated in the cable industry.

e. **Working Capital:** ETC concurs with the NOPR that the balance sheet approach be adopted. The advantages of the Balance Sheet approach are:

1. It is simple, easy to use, and does not require excessive time and expense.

2. It closely follows the accounting definition of working capital. The accounting definition is that the total working capital of an entity is equal to the difference between its current and accrued assets and liabilities.

3. It uses actual data from the Company's balance sheets and thus avoids any determination or approximation of lags.

4. It provides a true match between rate base (including working capital) and all sources of capital by considering all items on the balance sheet.

5. It is fair to both ratepayers and investors as it allows a fair return on all the investor-supplied working capital without unjustifiably charging the ratepayers for cost-free capital provided by vendors, employees, taxing authorities and others.

6. Accounting is a closed system. Items which affect the income statement are directly related to the balance sheet; therefore, the results of this method <u>will be close</u> to the results of a properly conducted lead-lag study.

3. <u>RATE OF RETURN</u>: There are two elements related to the overall rate of return - capital structure and the cost of each element of the capital structure. The capital structure should reflect a balanced structure and should not include disproportionate amounts of equity and debt. If the actual capital structure is not balanced, then a hypothetical structure should be adopted.

The issue of return on equity is the most time consuming in a regulatory proceeding. Therefore, it may be useful to adopt a standard method based on the DCF. The debt cost should be based on the actual embedded cost but the debt cost should exclude the extraordinary high costs of debt caused by private debt placement and imprudent actions of a cable company. A benchmark return on equity may be developed quarterly. The use of benchmark returns will award the efficient companies and penalize the inefficient ones. It could also avoid allocation of resources required to litigate the issue of return on equity.

For small companies, an abbreviated standard approach may be adopted.

On page 13, the NOPR suggests a post tax return of 10-14% which is too high in view of the current cost of capital in today's economy.

4. OPERATING EXPENSES: ETC is in agreement with the NOPR that only those operating expenses which are required to provide regulated service should be allowed. There are three aspects of operating expenses upon which ETC submits its comments. These are:

   a. Capitalization versus expensing.

   b. Allowable expenses.

   c. Income taxes.

   a. **Capitalization versus Expensing**: The FCC should establish clear criteria for the expenses which should be capitalized and the expenses which should be expensed. These criteria could follow the guidelines of GAAP and the IRS.

   b. **Allowable Expenses**: The FCC should establish certain criteria for allowing expenses. The suggested criteria are:

      1. Expenses which are necessary to provide service to customers.

      2. Expenses which are prudently incurred.

      3. Expenses which represent normal conditions.

      4. Expenses which are recurring, i.e., non-recurring expenses should not be included.

      5. Expenses which are not speculative.

      6. Expenses which have not been disallowed by the Internal Revenue Service (IRS).

      7. Expenses which are incurred during the test period.

c. **Income Taxes**: Although ETC prefers that only current income taxes and all tax benefits be flowed through in the COS, the tax laws may require the normalization of future or deferred federal income taxes. If the FCC adopts the normalization rather than the flow through of deferred taxes or tax benefits, ETC recommends that only those tax benefits be normalized which are mandated by law. All other tax benefits should be flowed through as this process will allow the inclusion of actually incurred and not hypothetical income taxes in the COS.

5. DEPRECIATION AND AMORTIZATION: ETC concurs with NOPR that the depreciation and amortization rates should reflect the actual useful life of assets. The FCC should prescribe industry wide depreciation rates for various plant categories. The use of standard rates would avoid unnecessary costs associated with the preparation of company-specific depreciation studies and associated litigation. The depreciation rates for a specific plant do not vary much from company to company.

   The depreciation rates should be based on whole life rather than the remaining life and should be based on the book value because this approach appropriately results in the recovery of cost invested by the investors.

6. COST ALLOCATION: A proper cost allocation is a prerequisite for a proper rate design and pricing. The issues related to cost allocation are:

   a. **Cost Classification**: The FCC should prescribe criteria for the classification of costs into fixed, customer related, channel related, distance related, etc.

   b. **Cost Allocation**: The following are two basic cost allocation issues:

      1) Cost Allocation to Regulated Business: There is a common tendency to allocate costs to regulated business to the maximum possible. All direct costs needed to provide regulated services should be carefully recorded. All the common costs should be assigned to regulated and non-regulated business based on proper allocation factors. Common costs associated with the plant in service should be allocated based on the plant ratio (ratio of regulated plant to the total plant without common plant) and the common costs associated with manpower should be allocated based

on the labor ratio (ratio of salary and wages of employees working directly for regulated services to the total salary wages without the common salaries and wages).

2) Allocation to Franchises: As NOPR suggested, there are two basis for developing revenue requirement - one is based on the allocation to different franchises and the other is to compute revenue requirement on a company-wide or MSO-wide basis. In the case of electric and gas utilities, generally the rates are computed on system-wide basis and these rates are referred to as postage stamp rates. The system-wide cost of service is easy to compute and does not differentiate between various franchises. This approach also avoids the problems associated with cost allocation among franchises as cost allocation is not a perfect science. The adoption of different allocation methods could result in either over recovery or under recovery of total costs by a cable company. The cost allocation among franchises could also result in extensive litigation and costs which are generally passed on to ratepayers. Therefore, the approach based on system-wide costs is preferable. An exception may be in the case of large franchises or decentralized franchises located in different geographic areas, where it may be desirable for costs to be allocated to franchises.

   In allocating costs to franchises, the costs may be allocated based on number of customers, number of channels and distances involved. Before allocation, the regulated business costs need to be classified to fixed, customer related, channel related, and distance related costs.

7. ANNUAL INFLATION ADJUSTMENT: ETC agrees with the use of the inflation GNP-PI for indexing if inflation indexing is to be permitted. ETC strongly supports the use of the increase in productivity as an offset. Only positive increases in productivity should be used. ETC also supports the use of the telecommunication industry productivity as an offset as it would encourage the increase in productivity in the cable industry.

8. <u>COLLECTION OF INFORMATION</u>: ETC supports the concept of submission of information on an annual basis as is done by electric and gas utilities regulated by Federal Energy Regulatory Commission (FERC). The annual report submitted by electric utilities is known as Form 1 and submitted by gas or interstate pipelines is known as Form 2.

As long as a cable company has an annual audited report, it should be required to submit information on an annual basis. The details required by large and small companies may be different. The cable companies may be divided into three categories - large, medium, and small. The annual reports should be submitted on standardized forms and may be designated as Form C-1 for large cable companies, Form C-2 for medium cable companies, and Form C-3 for small cable companies.

9. <u>RATE DESIGN</u>: The rate design should be:

a) Cost based to the maximum extent possible.

b) Fair to all customers and non-discriminatory.

c) Should be easily understandable.

The rate design could be a one part rate, i.e., a flat monthly fee, or a two part rate, i.e., a monthly customer fee - same for all customers and channel fee - based on number of channels subscribed to by a customer. If the number of channels offered does not vary much from customer to customer, the one part rate is the proper rate. If the number of channels subscribed to by customers vary significantly, then the two part rate should be adopted.

There could be additional rates for additional services.

CONCLUSION:

ETC supports the use of COS standards for establishing cable company rates. It is essential for the FCC to establish standard procedures for computing cable companies' rates. The regulatory process should be simple and easily understandable. The rates based on a standardized COS study achieves this objective.

Respectfully Submitted,
Economic and Technical Consultants, Inc.

By J. Kumar

Jatinder Kumar, President
Economic and Technical Consultants, Inc.
6241 Executive Boulevard
Rockville, MD 20852
Voice (301)-984-7050
Fax (301)-984-7053

Admin\fcc.rm
Aug 24, 1993